IT 00-21
Tax Type: Income Tax
Issue: Inclusion of Capital Gains and Base Income

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
ADMINISTRATIVE HEARINGS DIVISION
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS,	**No. 98-IT-** **FEIN:**
v.	
ABC ANNUITY CORPORATION,	**Christine O'Donoghue** **Administrative Law Judge**
Taxpayer	

RECOMMENDATION FOR DISPOSITION REGARDING THE PARTIES' CROSS-MOTIONS FOR SUMMARY JUDGMENT

This matter arose after ABC Annuity Corporation and FIRST ABC Life Insurance Company (hereinafter "ABC" and "FIRST ABC" or collectively "taxpayer") timely protested a Notice of Denial that the Illinois Department of Revenue ("Department") issued for the tax year ending 4/15/93.

The parties have filed Cross-Motions for Summary Judgment in this matter. The dispute here involves whether the capital gain on the deemed sale of taxpayer's assets pursuant to Internal Revenue Code Section 338(h)(10) must be included in the computation of taxpayer's Illinois Income tax liability. After a thorough review of the parties' motions, the exhibits attached thereto and memoranda filed, it is my recommendation that summary judgment be entered for the Department and taxpayers' motion for summary judgment be denied.

FACTS NOT IN DISPUTE:

1. During 1993, XYZ Company was the common parent company of several subsidiaries including XYZ Financial Services, Inc., ("XYZ") Taxpayer's Attachment 1 and Taxpayer's Ex. No. 1.
2. During 1993, XYZ wholly-owned BUSINESS Corp. BUSINESS Corp wholly-owned the two life insurance companies, ABC and FIRST ABC, at issue in this case. Taxpayer's Attachment 1 and Taxpayer's Ex. A.
3. For the tax year ending 12/26/93, XYZ Co. filed a federal consolidated income tax return with various subsidiaries. Taxpayer's Attachment 1. The 1993 federal consolidated return included BUSINESS Corporation, ABC, and FIRST ABC through the date of their sale, April 15, 1993. Taxpayer's Attachment 1 & Taxpayer's Ex. A.
4. On April 15, 1993, XYZ sold 100% of the stock of BUSINESS Corp. to MMM Corporation, an unrelated entity. Taxpayer's Attachment 1.
5. XYZ elected to treat the stock sale as a deemed asset sale pursuant to I.R.C. §338(h)(10) which required ABC and FIRST ABC to report capital gain in the federal consolidated return on the deemed sale of their corporate assets. Taxpayer's Attachment 1.
6. On ABC and FIRST ABC's combined Illinois income tax return for the short period ending 4/15/93, ABC and FIRST ABC did not include the Section 338(h)(10) capital gain in its Illinois base income. Taxpayer Attachment 1 and Taxpayer's Ex. B. Taxpayer excluded this capital gain by taking a subtraction modification on Line 5(f). Taxpayer's Ex. B.
7. The Department issued a notice of math error to ABC and FIRST ABC disallowing the subtraction modification. Taxpayer's Attachment 1.

8. On May 22, 1998, ABC filed an IL1120-X for the short period ending 4/15/93 claiming a refund in the amount of $128,222 (plus interest and penalties of $84,471.38). Dept. Ex. A.

9. On May 26, 1998 the Department issued a Notice of Denial for the tax year ending 4/15/93. Dept. Ex. B.

CONCLUSIONS OF LAW:

A motion for summary judgment is appropriate where the pleadings, affidavits, and other documents on file show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law. 735 ILCS 5/2-1005(c); People ex rel. Department of Revenue v. National Liquors Empire, Inc., 157 Ill. App. 3d 434 (4th Dist. 1987). Summary judgment is also appropriate when the parties agree on the facts, but dispute the correct construction of the applicable statute. Bezan v. Chrysler Motors Corp., 263 Ill. App. 3d 858, 864 (2nd Dist. 1994). Here, the only issue is a legal one, that is, whether ABC and FIRST ABC must include capital gain on the deemed sale of their assets pursuant to Internal Revenue Code §338(h)(10) in computing their Illinois income tax liability. Accordingly, an action for summary judgment is appropriate.

On April 15, 1993, XYZ sold 100% of its stock in its wholly-owned subsidiary, BUSINESS to MMM Corporation, an unrelated entity. Taxpayer Attachment 1. XYZ made an election pursuant to I.R.C. §338(h)(10) to treat the stock sale as a deemed asset sale. Generally, Section 338(h)(10) provides that if a target corporation recognizes gain or loss as if it sold all of its assets in a single transaction, then no gain or loss will be recognized on stock sold or exchanged in the transaction by members of the selling consolidated group.

The dispute involves whether this Section 338(h)(10) capital gain must be included in the computation of taxpayer's Illinois income tax liability. The Department maintains that the capital gain must be included because Section 203(e) of the IITA adopts federal taxable income as the starting point for computing Illinois base income and the capital gain was included in taxpayer's federal taxable income. Dept. Brief pp. 1, 2. The taxpayer, however, argues that Section 203(e)(2)(E) of the IITA requires that affiliated group members filing a federal consolidated return recompute their respective taxable income amounts as separate corporate entities, therefore, the gain from the deemed asset sale does not flow through to Illinois base income. Taxpayer's Brief p. 5. Further, it argues since the Section 338(h)(10) gain was attributable to the activity of another affiliated group member which made the election on the federal consolidated return, the gain cannot be included in the separate federal taxable income of ABC or FIRST ABC. Taxpayer's argument rests upon Section 203(e)(2)(E) which provides that the taxable income:

> In the case of a corporation which is a member of an affiliated group of corporations filing a consolidated income tax return for the taxable year for federal income tax purposes, taxable income determined as if such corporation had filed a separate return for federal income tax purposes for the taxable year and each preceding taxable year for which it was member of an affiliated group.

35 **ILCS** 5/203(e)(2)(E).

Section 203(b)(1) of the IITA provides that Illinois base income is an amount equal to the taxpayer's taxable income with certain modifications outlined in paragraph 2. 35 ILCS 5/203(b)(1). Section 203(e)(1) provides that taxable income is the amount of taxable income reportable for federal purposes under the provisions of the I.R.C. 35 ILCS 5/203(e)(1). The analysis must begin, therefore, with the I.R.C. to determine whether the Section 338(h)(10) capital gain is included in the separate federal taxable income of ABC and FIRST ABC.

Section 338 of the Internal Revenue Code (I.R.C.) provides in relevant part:

Sec. 338. Certain stock purchases treated as asset acquisition.

(a) General rule.

For purposes of this subtitle, if a purchasing corporation makes an election under this section (or is treated under subsection (e) as having made such election), then, in the case of any qualified stock purchase, the target corporation –

(1) shall be treated as having sold all of its assets at the close of the acquisition date at fair market value in a single transaction, and

(2) shall be treated as a new corporation which purchased all of the assets referred to in paragraph (1) as of the beginning of the day after the acquisition date

26 U.S.C. 338(a).

Section I.R.C. §338(h)(10) provides as follows:

(10) Elective recognition of gain or loss by target corporation, together with nonrecognition of gain or loss on stock sold by selling consolidation group.

(A) In general. Under regulations prescribed by the Secretary, an election may be made under which if –

(i) the target corporation was, before the transaction, a member of the selling consolidated group, and

(ii) *The target corporation recognizes gain or loss with respect to the transaction as if it sold all of its assets in a single transaction*, then the target corporation shall be treated as a member of the selling consolidated group with respect to such sale, and (to the extent provided in regulations) no gain or loss will be recognized on stock sold or exchanged in the transaction by members of the selling consolidated group. (emphasis added)

Generally, a Section 338 election provides that the selling corporation recognizes gain on the sale of stock and the target company recognizes gain on the sale of assets. Since both entities

recognize gain under these circumstances, many taxpayers look to subsection (h)(10) of Section 338 which provides that no gain or loss will be recognized on stock sold or exchanged in the transaction by members of the selling consolidated group if the target corporation recognizes gain or loss with respect to the transaction as if it sold all of its assets in a single transaction.

Although the taxpayer argues that the Department is violating Section 203(e)(2)(E) by including the gain, an analysis of the IRC reveals otherwise. In order to make a Section 338(h)(10) election, the target must account for the sale as a deemed asset sale as provided for in Section 338(a). Section 338(h)(10)(A) merely allows the deemed sale to be accounted for as part of the former affiliated group's consolidated return, rather than on a separate return of the target corporation. The election the target makes to account for the sale as a deemed asset sale is unrelated to the taxpayer's membership in an affiliated group. Thus, taxpayer's federal taxable income, the starting point for computing Illinois income tax liability, even computed on a separate company basis, includes the gain it recognized from the deemed asset sale. The taxpayer must, therefore, include this gain on line 1 of its IL1120 in the computation of its Illinois base income. Further, the Department correctly disallowed taxpayer's subtraction modification for the amount of the capital gain, since the IITA does not specifically provide for such a subtraction modification. *See*, 35 ILCS 5/100 *et. seq*; Taxpayer's Exhibit B.

The taxpayer repeatedly refers to this gain as "fictitious," however, it clearly is not as the Section 338(a) election merely allows the transaction to be treated as an asset sale rather than a stock sale. The selling company recognizes no gain or loss on the sale of stock and the target corporation receives a step up in the asset's basis equal to the amount of gain recognized. *See*, IRC Sec. 338(b). Not recognizing the federal election would require a target corporation to separately compute the basis of its assets for Illinois and federal purposes. Illinois has long held

the position that the Section 338(h)(10) election should be recognized for state tax purposes and no section of the IITA precludes the Department from taking this position or requires that the election be reversed. *See e.g.* IT 95-16 & 89-141. Further, the taxpayer's reliance on Bodine Electric Company v. Allphin, 70 Ill. App. 3d 844 *affirmed* 81 Ill. 2d 502 (1980) is misplaced. Bodine merely stands for the proposition that the taxpayer must compute federal taxable income as determined on a separate company basis as its Illinois base income before modifications. It does not follow that the gain that was included in taxpayer's federal taxable income should be excluded in the computation of its Illinois income tax liability.

Lastly, the taxpayer concludes in its brief in a most general fashion that the inclusion of the gain in the computation of Illinois taxable income violates the reasonable classification and uniformity requirements of the Illinois Constitution of 1970. Taxpayer, however, failed to support this conclusion with any legal argument, therefore, it has failed to meet its burden of proving that it is entitled to judgment as a matter of law on this foregoing ground.

Wherefore, for the reasons stated above, it is my recommendation that the Taxpayer's Motion for Summary Judgment be denied and the Department's Motion for Summary Judgment be granted.

Date: March 30, 2000

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Administrative Law Judge